A Closer Look At Emerging Markets

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Many pension funds have looked to increase their allocation to emerging markets over the last year, and with good reason. Strong headline GDP and consumption growth, booming infrastructure projects and continued urbanization still resonate with investors. But in light of a continued rise in valuations, some investors are beginning to wonder whether a bubble is building. We believe that, while prices have run a long way, there is still a lot of value in emerging markets, if one is selective as to where to allocate your capital.

Let's first take a step back and look at the drivers behind the investment case for the emerging markets. The first impulse of many investors seeking emerging market exposure may be simply to buy the index or a strategy that looks very much like the index. However does this approach actually deliver what investors are expecting? Let's take the MSCI Emerging Market Index, for example. Looking at the top ten holdings within the index you can see it is made up of many large capitalisation cyclical stocks such as Petrobras in Brazil, Samsung Electronics in South Korea and Gazprom in Russia. However, even though these heavyweights are based in developing countries, their fortunes are very much more closely tied to the global economic cycle and in particular the success, or otherwise, of the large Western economies in North America and Europe, whether that be developed market demand for oil or US and European consumers' demand for television sets. So buying a basket may seem attractive at the outset but it may not give the pure exposure one might expect to the growth in evidence in many emerging countries' domestic economies.

The next logical step is to take a closer look at individual markets. Conventional wisdom suggests countries with the highest economic growth rates will deliver the best returns to investors. However, on closer inspection the picture is not as straightforward as that. Looking at independent academic analysis and bringing this up to date to 2009 we have looked at the relationship between growth in GDP per-capita and equity returns, both in developed markets as well as in emerging markets. As Figure 1 clearly shows, from 1900-2009, over long periods and when adjusted for inflation, developed stock market returns and GDP per-capita growth are in fact negatively correlated. Turning to the emerging world, Figure 2 shows the same data over the more recent period of 1988 to 2009. Here the correlation is still very hard to find. Hence, although it may seem counterintuitive, the empirical data clearly show that GDP per-capita growth and stock market returns are not correlated over long periods.

There are a number of reasons for this. Firstly GDP is analogous to sales, stock market returns to corporate profits. GDP does not reflect the profitability of those sales so that if sales are strong and corporate profits are low, share prices are unlikely to appreciate. A second reason is that the stock market does not reflect the full economy so the performance of private, government-owned and newly formed companies generally is not reflected here but is captured by GDP. We also believe corporate governance is important with shareholder rights being better protected in some countries than others where political interests or the personal interests of a majority investor can override.

Looking at the relative performance of some emerging markets can uncover some surprising results. Many investors have been drawn to the economic boom in China over the past two decades with yearly GDP growth rates averaging nearly 10%. One might have assumed this would have filtered through to the equity market. In comparison Mexico has perhaps been a less fashionable market for commentators with annualised GDP growth of just 2.7% since 1994. However if you were to compare the stock market returns of these two markets over the same period you get a very different picture as illustrated in Figure 3. Mexico's equity returns compounding annually at 12.9% have considerably exceeded those of China of just 1.8%.

We do not mean to suggest that GDP growth is irrelevant. Perhaps, though, too much time is spent on forecasting GDP growth to make sound long-term investment decisions. It is very possible to find companies that have excellent investment potential in countries where GDP is growing either rapidly or slowly. A company that operates in a slower-growth country and has strong competitive advantages, good management, and excellent corporate governance, can be a great investment.

So if the emerging markets mega-caps do not offer true emerging markets exposure and focusing on the fastest-growing economies is not a good guide, where else can one look? At Vontobel we believe that the real value lies in the high-quality growth that can be found in the local economies and stocks that are more clearly focused on domestic consumption growth, superior earnings prospects and a clear focus on local markets. Following this logic, it can even make sense to include western multinationals in an emerging markets portfolio. This may seem odd at first, but developing countries in Asia and Africa

Figure 1: GDP / Capita vs. Stock Returns 1900-2009 (16 Developed Countries)

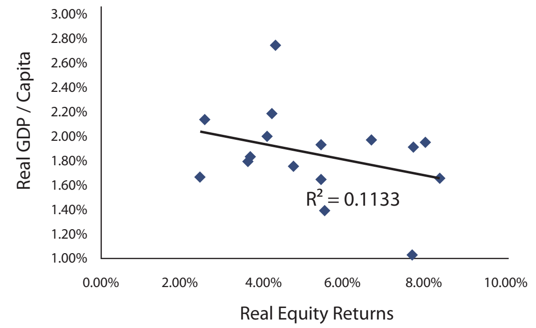
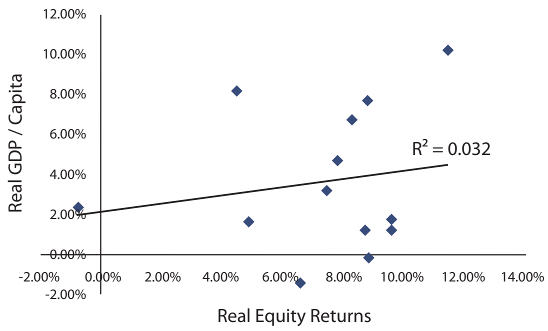
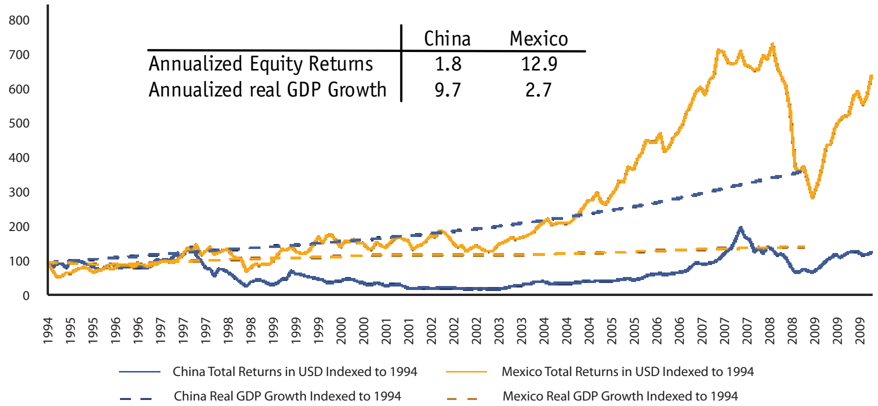


Figure 2: GDP / Capita vs. Stock Returns 1988-2009 (13 Emerging Countries)



Source: Jay Ritter's Economic Growth and Equity Returns for 1900-2002 data
World Bank's World Development Indicators for GDP data 2003-2009 (2009 are preliminary numbers)
FactSet Aggregates for 2003-2009 Returns data
All data is adjusted for inflation and is the geometric average of yearly data in the period

Figure 3: Mexico and China Real Equity Returns Since 1994



Source: MSCI; Bloomberg

are the growth drivers for many western consumer goods companies.

In other words, to really take advantage of specific opportunities in a given market, you need a bottom up approach based on stock-selection. Different managers follow many different philosophical approaches, and we are aware of that. However, at Vontobel our overriding belief is that, while short-term returns can be volatile, long-term equity returns are driven by long-term earnings growth. By identifying sensibly-priced, high-quality companies, that can grow earnings faster than the market on a sustainable basis, we can be more successful in the long run than by chasing companies exposed to shorter term cyclicality. In turn holding on to a high-quality stock for a long period of time, sometimes despite occasional temporary underperformance, we believe is better than frantic changes to the portfolio.

So which markets and sectors do we believe are the most promising at this stage in the development of the emerging markets? If we cut down the list of possible candidates to the so-called BRIC countries, India and Brazil clearly stand out. Corporate earnings in these two markets are generally strong and follow country-specific patterns, offering investors some degree of hedging against developments in the U.S., for example.

India is a favourite due to a very young average population and pent-up demand, especially in rural areas. The country's corporate sector is generally well-run and banking regulation is up to the highest standards. Investing in consumer staples is an obvious choice. Indian consumption of detergents and shampoo, for example, clearly trails that of China with per-capital consumption reaching 60% and 30% of Chinese levels, respectively. In areas such as cosmetics and ice-cream, the gap is even wider with Indian consumption standing at just 10% of China's. Producers of generic pharmaceuticals are also attractive due to good growth prospects at home and abroad. True, valuation multiples for some of the front-runners can be higher than for comparable companies in other countries, but good long-term earnings prospects make up for such drawbacks. Less attractive segments include Indian property developers, which rely too heavily on property price increases.

Brazil is a compelling investment case thanks to the strength of the economy, a good legal framework and a sound corporate structure supported by solid banking system. More than other emerging markets, companies have incentives to adopt good practices of corporate governance. Companies in Brazil are rated according to their adherence to standards of corporate governance with the highest level being the Bovespa Level II. Companies are not forced to follow these practices but those who do tend to trade at a premium. Nowadays it is unusual for a company to issue an IPO in the Brazilian market without adopting the standards of the Bovespa Level II. In addition, Brazilian corporate law requires publicly-traded companies to pay a minimum dividend of 25% of earnings. We believe that dividend growth is one of the best ways to look at the connection between long-term business growth and stock price return. Sectors such as consumer staples, utilities, commercial services and banking are promising, with a multitude of competitive companies to choose from.

China is a different story. Economic growth there is being driven by a massive government-led investment, funded by a splurge of credit. State-owned enterprises (SOEs) have been the prime beneficiaries, though this has been accompanied, particularly in the infrastructure sector, by a decline in profitability, while the banks have been compromised as lending has often been made with little regard to asset quality. In turn this massive investment has further intensified one of the country's main economic weaknesses: overcapacity. Whilst helping to drive top line growth in some sectors this investment has, therefore, often occurred without creating shareholder value. Standards of corporate governance, in turn, compound this with the first priority of management in China often being to support the government's policies, including job creation and the development of the local economy, rather than with driving profitability. Whereas in most western economies, management is compensated when they reach specific financial targets, in China management is often rewarded (through promotions to prominent positions in the Communist Party) when they achieve government policy objectives. As a result we believe few Chinese companies offer the type of valuations, clarity and sustainability of better relative opportunities elsewhere.

In conclusion we do believe specific emerging markets still offer a convincing case, but to achieve long-term return goals a focused bottom-up approach is necessary. Necessary to find the best businesses that will not only benefit the most from the booming domestic demand in developing countries but also transfer that growth to shareholders. This is in contrast to an indexed strategy or top-down approach that can lead to investment in less efficient businesses and those more exposed, instead, to the global economic cycle and the slower growth of developed markets.